UNITED STATES DEPARTMENT OF AGRICULTURE
Rural Electrification Administration
Washington 25, D. C.

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ACCOUNTING AND AUDITING MEMORANDUM 303

SUBJECT: Audits by Certified Public Accountants

For several years, REA has requested those borrowers attaining sufficient experience in management and adequate financial stability to have their accounts audited annually by certified public accountants. When a borrower qualifying under this policy has selected its auditor and they have agreed upon the scope of the audit and the fee to be charged, REA considers and passes upon the borrower's selection. REA does not endorse or approve any auditor or accounting firm on a blanket basis, but considers each case individually. The auditor should not be permitted to begin his initial engagement until notice of REA approval has been received. REA approval is valid for successive audits for the particular borrower until it is rescinded.

To have the auditor independent of management, initial responsibility for the selection is vested in the board of directors. If desired, the members may formally ratify the selection made by the board. While each audit is required to meet certain minimum standards described in a manual "An Audit Program for Certified Public Accountants Examining the Books of REA Borrowers," the board must determine whether or not the scope of the audit engagement should be enlarged over the minimum requirements in order to serve the borrower's best interests. Board members, therefore, will be interested in knowing the nature and limitations of financial audits.

In selecting the auditor and determining the scope of the audit, it is necessary for the board of directors to recognize that professional accountants are governed by certain auditing standards. These standards are the underlying principles which control the nature and extent of evidence the auditor obtains during the course of the audit by means of recognized procedures. As a general rule, certified public accountants employ the procedures and do the sampling they deem adequate in the particular circumstances. Rarely is a detailed audit resorted to.

The following standards govern generally a certified public accountant's conduct of an auditing engagement.

1. The examination is performed by a person or persons having adequate technical training and proficiency in auditing.

2. The auditor is independent and unbiased in his attitude.

3. Due professional care is exercised in the performance of the examination and preparation of the report.

4. The work is adequately planned and any assistants are properly supervised.

5. There is a proper study and evaluation of the existing internal control. In reliance thereon, auditing procedures frequently are restricted to tests or sampling.

6. Sufficient competent evidence is obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the accounts and financial statements under examination.

7. The report states whether the financial statements are presented in accordance with generally accepted principles of accounting and whether such principles have been consistently observed in the current period in relation to the preceding period.

8. The financial statements include such descriptive terms and notes as are necessary to accomplish disclosure of all significant financial facts.

We believe the members and the board of directors should understand that the primary purpose of an audit by a certified public accountant is to enable him to express an opinion as to the fairness of the financial statements, their compliance with generally accepted accounting principles, and the consistency of the application of those principles. Ordinarily, an audit is not designed and cannot necessarily be relied upon to disclose misappropriation of funds, although the discovery of irregularities frequently results. In a well organized business reliance for the detection of financial irregularities is placed principally upon the maintenance of an adequate system of accounting records with appropriate internal control. By internal control we mean the plan of organization, the division of responsibilites among employees, and all other methods adopted to safeguard assets, have accurate and reliable accounts, promote operational efficiency and carry out prescribed managerial policies.

If the outside auditor were to attempt to discover defalcations and similar irregularities he would have to extend his work to a point where its cost would be prohibitive. Good internal control and surety bonds will ordinarily provide protection more economically. On the basis of an examination by samples and checks made in the light of his

review and tests of the system of internal control, the auditor relies upon the integrity of his client's organization unless circumstances are such as to arouse his suspicions, in which case he would be required to enlarge his procedures to determine whether or not suspicions are justified.

It should be made clear to all concerned that the certified public accountant is in no sense an insurer or guarantor, nor do his training and experience ordinarily qualify him to act as a general appraiser, valuer, expert in materials, or attorney. REA borrowers are responsible for maintaining accounts to properly record transactions and adequate control to safeguard their assets. The transactions and recording of transactions are matters within the direct or primary knowledge of the borrower. The outside auditor's knowledge of them is secondary, based on his examination. He does not certify the figures appearing in the financial statements in the sense of guaranteeing or warranting their correctness but he merely expresses an opinion with respect to them. The primary responsibility for the accuracy of the accounts and financial statements rests upon the borrower's management. It is fundamental that the management cannot discharge its obligation to maintain adequate records and furnish accurate financial information by the employment of an outside auditor. The auditor's certificate is not a substitute for management's accounting of its stewardship but is rather a check upon the management's accounting. It would be wholly erroneous to give it any broader construction.

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